Chamberlyns

In Perspective

The Curve Ball

January 2015

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Many believe that guessing where interest rates are heading is the best way to manage the fixed interest element of their investment portfolio. But is it?

Market expectations about interest rates change because of news. This makes it very, very difficult to build a coherent investment strategy around a forecast.

In a recent article, Bloomberg News noted that the rally in the US Treasury market in 2014 was stronger than every economist surveyed by its journalists had predicted.[1]

As such, US 10 year Treasury yields were around 2% at the end of 2014, down from just over 3% at the end of 2013 (remember with the bond 'see- saw', yields fall as prices rise and vice versa), so those who heeded economists' forecasts and backed out of bonds will have missed some or all of this capital return.

Indeed, this isn't just a US story: Japan's 10 -year government bond yield hit its lowest levels in 16 months in late August 2014, while European bond yields also tumbled to record lows. So why did many economists get their interest rate calls wrong? It could be for a variety of reasons: economic growth and inflation may have been below their assumptions; geopolitical strains may have dampened risk appetites; central banks may have adjusted their timetable for withdrawing monetary stimulus etc.

The important point is that market prices / yields change on news and unless you have a way of forecasting news, you are unlikely to enjoy consistent success in basing your fixed interest strategy on anticipating changes in interest rates.

Diversification: different countries, different conditions.

Luckily, there is another way of managing fixed interest, which doesn't require predicting interest rates. Rather, it involves diversifying globally and using the information in the market at any one time to work out in which areas of the market to deploy capital.

Part of the benefit of diversification is that interest rate cycles vary across economies, reflecting differences in expectations for inflation, economic growth and other indicators. For example, while benchmark rates in many economies remain at record lows, New Zealand raised its base rate four times in 2014. Elsewhere, while markets anticipate the Bank of England raising rates, there has been speculation that the European Central Bank will announce further stimulus to ward off deflation.

The non - correlated nature of interest rate movements implies that seeking to spread risk and capture opportunities globally across developed markets, can reduce volatility and deliver additional returns across one's portfolio.

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Diversification: 'yield curves' and the information that's already out there.

An additional aspect of a sensible, well-diversified, non-forecasting approach is to vary maturities in a portfolio by buying, selling or holding bonds depending on the state of today's 'yield curve', not guesses about the future (think of a yield curve as a graph which provides insights into, and enables comparisons between, the yields of similar types of bonds of different maturities).

A normal yield curve slopes upwards, reflecting the additional return investors require and should ordinarily expect for committing their capital for longer periods - or in other words, for taking 'term risk', which is the same principle as applies with savings accounts. Contrarily, sometimes yield curves can flatten or invert and when this happens, it means there is little or no premium on offer for tying up your money for longer periods.

So, if the yield curve slopes upwards, it may pay to take more term risk because you are being compensated for it. Conversely, if the curve is flat or inverted, there is little or no compensation for taking on term risk, so it may be wiser to remain in shorter-dated bonds.

No forecasting, market timing or assumptions about the direction of interest rates are required here; instead, today's yield curves are utilised to work out where to allocate term risk in a portfolio ('credit risk' is the other key risk exposure around which decisions are required across one's fixed interest holdings) and improve the likelihood of favourable outcomes over time.

Chamberlyns firmly believes in using today's market prices to form efficient strategies based on the information that is already out there. As such, there is significant evidence that correctly forecasting interest rates with any consistency is impossible (even more impossible than correctly forecasting stock price movements), so it is wise not to waste one's time and resources trying and instead focus on the things that we can exert some control over i.e risks, costs, sensibly trying to capture the sources of expected returns etc.

Of course, everyone has, and is entitled to, an opinion about the interest rate outlook. The problems arise when trying to base long-term investment decisions on expectations for interest rates, only to see them confounded by the curve ball of new information, which is immediate in impact, continuous and uncontrollable.

Best regards

Michael

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In addition to being a Chartered Financial Planner, Michael holds the globally recognised Certified Financial Planner qualification and is a Fellow of the Personal Finance Society. Michael also sits on Chamberlyns' Investment Committee and produces the firm's regular series of concise 'In Perspective' articles, which consider, and provide perspective on, a range of current and timeless wealth planning issues.

Chamberlyns provides a refreshingly different Wealth Management service for executives and professionals, who want to make the most of their money and the life that lies ahead of them.

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